

Should Detroit Follow Central Falls' Bankruptcy Strategy?

by Joel R. Glucksman on August 6, 2013

In the wake of Detroit filing the largest municipal bankruptcy in U.S. history, many analysts are looking at the bankruptcy strategy of other cities that filed for protection, in order to examine trends, repercussions, and potential solutions that might apply to Detroit. Amid the various cities and counties that have filed as of late, the small town of Central Falls, Rhode Island, stands out as a potential - albeit draconian - model for municipalities that are insolvent.

Central Falls sought Chapter 9 bankruptcy protection two years ago and faced liabilities of \$80 million. Unlike other cities, whose filings have been marred and drawn-out by disputes over pensions, bonds, and claims, Central Falls prioritized its city bondholders over all other creditors, allowing it to emerge from proceedings with its credit intact only a year after filing.

The state of Rhode Island, anticipating Central Falls' bankruptcy, passed a law that imposed a statutory lien on the city's property taxes and then earmarked that revenue toward the city's bondholders in the event of a Chapter 9 filing, Fox Business noted in a recent analysis. It went on to explain that the statutory lien law changed the status of Central Falls' general obligation bonds from unsecured to secured, which guaranteed that bondholders would be repaid in full. In a bankruptcy, secured creditors must generally be paid in full before any other creditors can receive any payment.

Accordingly, the state's decision to favor the bondholders over all others allowed it to instill confidence in the bond market that obligations would be repaid. As a result, when Central Falls emerged from the bankruptcy proceedings, its ability to borrow was strong.

"It was probably one of the best orchestrated bankruptcies, because as they saw it coming and that it would be necessary for Central Falls to file for bankruptcy, ahead of that actual filing, Rhode Island was managing the process with an eye toward mitigating any spillover to other bondholders in the state," Lisa Washburn, a managing director at Municipal Market Advisors, told Fox Business.

Of course, the requirement to favor bondholders had real world consequences. The city's payroll was slashed during the bankruptcy by a third. Moreover, general creditors not lucky enough to be singled out for elevation to secured status only received about 45 percent on their claims. Finally, the pensions of retired workers suffered devastating cuts of up to 55 percent, and they were required to pay 20 percent of their health care costs.

Whether Central Falls is a model for Detroit is therefore a function of whether the observer is a retired worker, a general municipal creditor, or a Wall Street Banker.